the Primary Liability of Securities Lawyers

Manning Gilbert Warren III

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Recommended Citation
Manning Gilbert Warren III, the Primary Liability of Securities Lawyers, 50 SMU L. Rev. 383 (1997)
https://scholar.smu.edu/smulr/vol50/iss1/15

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# The Primary Liability of Securities Lawyers

*Manning Gilbert Warren III*

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## I. Introduction

Perhaps the least controversial aspect of the Supreme Court of the United States' recent decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*\(^1\) was its recognition that lawyers participating in a securities offering may be primarily liable under Section 10(b) of the Securities Exchange Act of 1934\(^2\) (the "1934 Act") and under one of its amplifying rules, Rule 10b-5,\(^3\) promulgated by the Securities and Exchange Commission (SEC). Indeed, in an otherwise intellectually incoherent opinion based on an intellectually incoherent methodology,\(^4\) the Supreme Court has invited investors to sue attorneys and other professional participants in fraud-tainted securities transactions as primary violators of Section 10(b) and Rule 10b-5.\(^5\) The Court, re-

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\(^*\) H. Edward Harter Chair of Corporate Law, University of Louisville. The author gratefully acknowledges the assistance provided by his research assistant, Paula Victoria Miller, and by his administrative assistant, Rita R. Clayton, in the final preparation of this Article.

2. 15 U.S.C § 78j(b).
jecting aiding and abetting liability not as bad policy but as beyond the scope of Section 10(b), stated, "Any person . . . including a lawyer . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." After all, the Court acknowledged, "In any complex securities fraud . . . there are likely to be multiple violators."7

Certainly many, if not most, of the lawyers who have been held liable as aiders and abettors under Section 10(b) and Rule 10b-5 could have been held liable as primary violators.8 In fact, the distinction between primary violators and aiders and abettors, according to SEC Chairman Arthur Levitt, "seldom had any practical significance" before the Central Bank decision.9 This is because defrauded investors worked on the universally established assumption that aiding and abetting liability was available to impose joint and several liability on those lawyers10 and because aiding and abetting liability was easier to prove. Thus the Court in Central Bank, by cracking the concrete of this long-held assumption, has required defrauded investors to relinquish the expediency of a three-element cause of action for aiding and abetting11 and return to the five-element cause of action judicially implied for primary violators of Rule 10b-

6. Central Bank, 114 S. Ct. at 1455. The availability of attorney primary liability under Section 10(b) was confirmed much earlier by the Supreme Court in Herman & MacLean v. Huddleston, 459 U.S. 375 (1983), in its discussion of the cumulative nature of federal securities law remedies. The Court noted that if Section 11 of the Securities Act of 1933 were the sole remedy for fraud in connection with registered offerings, investors would have no recourse against lawyers engaged in fraudulent conduct while preparing the registration statement. Herman & MacLean, 459 U.S. at 386 n.22.

7. Central Bank, 114 S. Ct. at 1455.


11. In IIT v. Cornfeld the Second Circuit listed the three elements of the aiding and abetting cause of action as follows: "(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation." IIT, 619 F.2d at 922.
The five elements of an investor’s implied private cause of action under Rule 10b-5 include “(1) a misstatement or an omission (2) of material fact (3) made with [the intent to deceive or] scienter (4) on which the [investor] relied (5) that proximately caused [the investor’s] injury.” Lawyers charged with primary liability typically defend themselves by attacking the first and third elements of the offense. They argue that even if a misrepresentation or omission were made, it was made solely by the client, not by the lawyer. They then argue the absence of intent, which in this context normally involves the question of whether the lawyer’s conduct recklessly departs from the applicable standards of care. It is, however,

12. See Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir. 1981), modified on other grounds, 459 U.S. 375 (1983). Federal courts addressing implied civil liability under Rule 10b-5 commonly enumerate five elements of the cause of action, sometimes combining two or more as one or otherwise failing to separate or identify additional elements. Id. In addition to those five hereinafter identified, see infra note 13 and accompanying text, proof of two additional elements is required: (1) the defendant’s conduct must be "in connection with" the plaintiff’s purchase or sale of a security; and (2) the plaintiff must suffer actual injury or damages. Huddleston, 640 F.2d at 555. Thus the “seven elements” of the implied private cause of action under Rule 10b-5 are as follows: (1) misrepresentation or omission; (2) materiality; (3) scienter; (4) reliance; (5) causation; (6) conduct “in connection with” the plaintiff’s purchase or sale; and (7) damages. Id. at 543, 555. In addition, in order to satisfy the standing requirement, plaintiff must be a purchaser or seller of the subject securities. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

13. Huddleston, 640 F.2d at 543.

14. In Magna Inv. Corp. v. John Does One Through Two Hundred, 931 F.2d 38 (11th Cir. 1991), the Eleventh Circuit stated:

We have defined “severe recklessness” as highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

Id. at 39 n.3 (quoting Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1982)).


The United States Supreme Court has repeatedly reserved the question of whether recklessness fulfills the requirement of scienter. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) ("We need not address here the question whether . . . reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."); Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980) ("We have no occasion here to address the question . . . whether, under some circumstances, scienter may also include reckless behavior."); Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983) ("We have explicitly left open the question whether recklessness satisfies the scienter requirement."). In Central Bank, the Court commented on the use of recklessness in an aiding and abetting analysis, but remained silent on its appropriateness in a primary liability analysis. Central Bank, 114 S. Ct. at 1455. Whether
those very standards of care applicable to securities lawyers, requiring the lawyer’s independent determination of the appropriate level of disclosure, which in most instances refute both arguments. Where the securities lawyer has failed to abide by these standards, he or she will have a difficult time escaping liability by simply casting all the blame on the client.

Thus, the requisite shift from secondary to primary liability should not prove particularly difficult. Most fraudulent securities transactions involving lawyer misconduct arise in factual circumstances that supply the supplemental elements necessary for a primary violation. Moreover, ample precedent both before and after Central Bank lends strong support for a facile transition. And, perhaps most importantly, assigning primary liability to securities lawyers more appropriately recognizes and reaffirms their “unique and pivotal” role in modern securities law practice and in the effective implementation of our securities laws. After all, it is the securities lawyer who controls the disclosure process and who undertakes to align the interests of the client issuer with the client’s investors.

The role actually performed by prudent securities lawyers preparing disclosure documents for both public and private securities offerings is frequently either misunderstood or forgotten by judges, academics, and other lawyers who are only occasionally confronted with professional liability issues in securities litigation. This gap in their understanding or lapse in their memories is typified by such frequently repeated remarks as “the lawyer is only a scrivener who papers the client’s deal,” “the lawyer is entitled to believe his client,” “the disclosures the lawyer drafts are made solely by the client,” “the lawyer is not a legal auditor,” “the lawyer represents the client and not the investors,” and “the lawyer should not tattle on the client.” Yet virtually no experienced securities lawyer could agree with any of these characterizations of his or her role in an offering of securities. These statements are last gasp defenses argued by trial lawyers in litigation; they are remote to the universe of a securities lawyer’s day-to-day practice. The securities lawyer involved in a securities offering, quite unlike the litigator, negotiator, or advisor in adversarial contexts, is an essential participant.

In this Article, I will first provide a brief description of the role and customary practices of securities lawyers in a securities offering in order to demonstrate their authority and control over the disclosure process. These customary practices, which reflect in substantial part the standards
of care applicable to securities lawyers as prudent experts in a highly specialized field of law, derive from a number of disparate sources. These sources include the ethical principles adopted by the American Bar Association (ABA) and the country’s highest state courts, the common law of torts, the various cautionary statements made by the SEC, as well as the views expressed by respected securities lawyers and scholars, and perhaps most importantly, the instructive, standard-setting language found either in the dicta or holdings of numerous judicial opinions. After briefly reviewing several of these sources, I will then address certain significant decisions that have reaffirmed the securities lawyer’s primary role in managing the disclosure process. This will lead to my conclusion that a securities lawyer whose conduct in preparing a disclosure document for a securities offering recklessly departs from the standards applicable in this highly-specialized area is not simply an aider or abettor, but a primary violator of Rule 10b-5’s antifraud proscription.

II. THE ROLE OF THE SECURITIES LAWYER

Any analysis of the securities lawyer’s role as an integral and essential participant in the securities offering must necessarily begin with the question of why that lawyer is involved and what he or she actually does. Given the complexity of state and federal securities regulation and the attendant liability risks under a wide array of state and federal antifraud provisions, the retention of experienced securities counsel is critical. Consequently, any party who decides to raise capital through the issuance of securities must retain an experienced securities lawyer in order to ensure compliance with state and federal securities law. These laws impose an array of requirements for either registration or exemption of the proposed offering, which affect the practicability, structure, size, and manner of the offering. These laws also generally require preparation of a disclosure document for the intended benefit of prospective investors, those third parties who the transactional participants, including the secur-


21. The statutory exemptions from registration are set forth in Sections 3 and 4 of the Securities Act of 1933, which have been expanded by the SEC pursuant to its rule-making authority. The most widely used regulatory exemptions from registration are found in Regulation D, and more particularly in Rules 504 and 505, adopted pursuant to Section 3(b), and in Rule 506, adopted pursuant to Section 4(2) of the 1933 Act. See generally Mark A. Sargent, The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform, 68 Wash. U. L.Q. 225 (1990); Manning G. Warren III, A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933, 33 Am. U. L. Rev. 355 (1984); Randolph H. Elkins & Larry M. Meeks, Regulation D (BNA Corp. Practice Series No. 51-2d, 1994).
ities lawyer, fully expect to utilize the information disclosed to make investment decisions. The securities lawyer has first-line and last-line responsibility for the production of this disclosure document—responsibility which includes not only gathering, verifying, and presenting the information to be disclosed, but also making literally thousands of intricate and complex determinations of what information is legally "material" and thus necessary for actual disclosure to prospective investors.

Moreover, the securities lawyer has a far larger role than researcher, fact checker, writer, and editor of the disclosure book. He or she is also the production manager for the entire disclosure process, from development of the disclosure plan to direction and implementation of the disclosure process, to final publication of the presumably nonfiction work disseminated by or on behalf of the issuer to prospective investors. The securities lawyer's responsibilities as production manager minimally include the following:

(1) Engage in a preliminary review to determine both the client's quality and integrity and any potential conflicts of interest that might result from the engagement.

(2) Form direct and oversee a competent working group for the disclosure process, including key officers of the issuer, the outside accountants, the underwriter representatives, if any, and the additional lawyers and other persons he or she determines should participate in the disclosure process.

(3) Establish a due diligence environment for the issuer and working group in which every participant has been sensitized to the disclosure requirements of the securities laws and the attendant risk of liability to investors.

(4) Conduct meetings with the officers of the issuer and other persons significantly involved in the issuer's business to gain a basic understanding of the terms of the offering and its purposes; the nature of the issuer's business, including its management, workforce, creditors, major suppliers, customers, assets, liabilities, revenues, competition, and other business risks; and the regulatory schemes applicable to the enterprise.

(5) Prepare a due diligence checklist for the issuer's management, requesting extensive information covering every major aspect of the issuer's organization, business, and management, and review the documents submitted to ensure satisfactory compliance with the request.

22. A misrepresentation or omission is "material" if there is a substantial likelihood that a reasonable investor would consider it important in determining whether to invest in the securities. See T.S.C. Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); see also Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), cert. denied, 409 U.S. 874 (1972). Authors of a major text in the securities law field have observed that "for the securities lawyer 'materiality' is the name of the game." Richard W. Jennings & Harold Marsh Jr., Securities Regulation: Cases & Materials 1023 (6th ed. 1987).

23. Numerous materials have been published that detail the securities lawyer's responsibilities in the disclosure process. See, e.g., Alan S. Guterman, Regulatory Aspects of the Initial Public Offering of Securities (BNA Corp. Practice Series No. 60, 1993); Charles J. Johnson, Jr., Corporate Finance and the Securities Laws 203-49 (1990).
and to determine what additional information is required for preparation of the initial working draft of the disclosure document.

(6) Prepare and distribute a directors, officers, and principal shareholders questionnaire covering each of these person’s background and experience, including any involvement in bankruptcy, criminal, civil, or administrative proceedings, ownership of the issuer’s securities, business transactions with the issuer, and other information related to their knowledge and participation in the issuer’s business.

(7) Prepare a presentation format and then an initial working draft of the disclosure document with appropriate headings for all probable categories of information, after review of sample documents used by other issuers in the same or similar businesses and after extensive consultation with the working group.

(8) Conduct and control an extensive “due diligence” investigation for the purpose of obtaining and verifying all material information necessary for inclusion in the disclosure document. At a minimum this would include, without limitation, a review of the issuer’s organizational documents and corporate minutes; stock transfer records and all documentation related to the issuer’s or any affiliates’ prior offerings of securities; audited and unaudited financial statements; budgets; marketing, scientific, or engineering studies; documents evidencing proprietary rights, including patents, copyrights, and trademarks; all of the issuer’s material contacts with customers, suppliers, and others; loan agreements; significant real and personal property leases; employment contracts and employee benefit plans; title opinions or policies relating to major real property holdings; liability and other insurance policies; collective bargaining agreements; all files related to pending or threatened litigation; all government permits and licenses and governmental regulations applicable to the issuer; and all other internal and external documents material to the issuer’s business risks; and its proposed use of offering proceeds. In addition to review of documentation, the due diligence investigation also requires extensive discussion of the information obtained, both with management and various accounting, legal, marketing, and operational personnel; discussion of the financial statements with the issuer’s outside auditors; actual physical inspection of the issuer’s major properties, plants, and equipment; discussions with third party experts of technical, scientific, or novel aspects of the issuer’s business; and investigation of the issuer’s current and past relationships with employees, creditors, major suppliers, and customers.

(9) Compare all information, written or oral, from each source with similar information from all other sources in order to identify, disclose, and reconcile material inconsistencies. This comparison is part of a larger, ongoing responsibility not only to obtain and verify information, but also to search for “red flags,” a broad term encompassing not only such informational and source inconsistencies, but all other matters that reasonably appear problematic, irregular, or questionable, or that otherwise give notice that something of impor-
tance has not been adequately explained or, if material, fully disclosed in the draft disclosure document.

(10) Write, edit, review, and revise various drafts of the disclosure document, in consultation with the entire working group; confirm the actual review and comment on the various drafts by each member of the working group; and reach consensus that the final draft fully and completely discloses all facts material to the issuer and its offering of securities. Even given a consensus, the securities lawyer must exercise his or her own independent professional judgment that the final disclosure document provides an understandable and balanced presentation of the strengths and weaknesses of the issuer and its securities offering, without obscurity, and that all textual statements are adequately documented.

In the end, it is the securities lawyer, not the client or any other member of the working group, who must make the final decisions as to what information will be provided in the disclosure document and whether his or her work product will be made available to the issuer for dissemination to prospective investors.

The foregoing sketch of the securities lawyer's role in the disclosure process is admittedly an insufficient guide for actual practice. The securities lawyer must consider numerous other matters in any particular securities offering depending on the registration form used as a disclosure guide and the vastly differing circumstances of each particular issuer. However, I provide it simply to demonstrate how the securities lawyer's role markedly differs from the role commonly assumed by most other kinds of lawyers in other types of transactions addressed by other areas of the law. For instance, in normal law practice, the lawyer is generally constrained by the client to include or exclude various terms or provisions in the transactional document; in the securities field, it is the securities lawyer who dictates the content of the document. In fact, it is common for the securities lawyer to become his or her client's benevolent adversary in the disclosure process by forcing the client issuer and its management to face issues they frequently would prefer to evade and by requiring disclosure of sensitive matters that may reflect negatively on their achievements and the marketability of the proposed offering. Thus, the securities lawyer's responsibility to ensure his or her own and his or her client's compliance with the securities laws by controlling the disclosure process serves to align both their interests with that of the investors protected by those laws.\(^4\)

III. THE SOURCES OF THE SECURITIES LAWYER'S STANDARDS

A. Rules of Professional Conduct

The standards of care applicable to the securities lawyer's conduct, and, indeed, the role those standards have established derive from many

\(^{24}\) See infra note 49 and accompanying text.
sources. Both the American Bar Association's (ABA) Model Rules of Professional Conduct,25 adopted by most of the states' highest courts, and the predecessor Model Code of Professional Responsibility26 serve generally as the foundation of the securities lawyer's standards of care.27 While they purport to establish only minimum standards of conduct, they do exert a statute-like influence over the behavior of lawyers. The most pertinent provisions are Model Rule 1.2(d),28 prohibiting a lawyer from assisting a client in conduct that the lawyer knows is criminal or fraudulent; Model Rule 1.16,29 requiring a lawyer's withdrawal where continued representation could violate the Rules; Model Rule 2.3,30 addressing a lawyer's evaluations for the use of nonclient third parties; Model Rule 4.1,31 requiring truthfulness in statements made to others; and Model Rule 8.4,32 prohibiting a lawyer from engaging in conduct involving dishonesty, fraud, deceit, or misrepresentation.

The ABA has amplified its principles through the formal opinions of its Ethics Committee. Perhaps the most pertinent of these are Formal Ethics Opinions 33533 and 346,34 which specifically advise lawyers in unregistered securities offerings to fulfill their independent disclosure obligation without blind reliance on the statements made by their clients. In Formal Ethics Opinion 335, the organized bar provided its first formal statement regarding the unique and pivotal role assumed by securities lawyers. It emphasized that the securities lawyer cannot assume either the completeness or accuracy of the client's representations, but must make his or her own independent investigation where the facts are suspect, inconsistent, open to question, or incomplete in any material respect.35 The securities lawyer must test the answers received from the client against the underlying records and other documents reasonably available. The ABA Ethics Committee reaffirmed this opinion almost a decade later in Formal Ethics Opinion 346 and added, "If the lawyer disagrees with the client over the extent of the disclosure made in the offering materials or over other matters necessary to satisfy the lawyer's ethical responsibilities as expressed in this Opinion, and the disagreement cannot be resolved, the lawyer should withdraw from the employment . . . ."36 Both opinions came as no surprise to securities lawyers with experience in preparing disclosure doc-

28. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2 ("Scope of Representation").
29. Id. Rule 1.16 ("Declining or Terminating Representation").
30. Id. Rule 2.3 ("Evaluation for Use by Third Persons").
31. Id. Rule 4.1 ("Truthfulness in Statements to Others").
32. Id. Rule 8.4 ("Misconduct").
uments for both registered and exempt offerings and who had long oper-
ated under standards that they continued to regard as considerably
higher. However, these opinions were standard-setting for tax lawyers
and other nonsecurities lawyers engaged by issuers in connection with
unregistered, exempt offerings of securities.

Then, in 1992, the ABA Ethics Committee added an exclamation point
to these earlier opinions. Formal Ethics Opinion 92-366 stated conclu-
sions particularly relevant to the standards of care applicable to the secur-
ities lawyer's conduct in creating a disclosure document work product.
The opinion provided that "the lawyer must withdraw from any represen-
tation of the client that, directly or indirectly, would have the effect of
assisting the client's continuing or intended future fraud" and should in
many cases "disavow any of [his or] her work product to prevent its use in
the client's continuing or intended future fraud, even though this may
have the collateral effect of disclosing inferentially client confidences ob-
tained during the representation." The ABA's opinion went on to state
that "the term 'assist' [in Model Rule 1.2(d)] must be construed to cover
a failure to repudiate or otherwise disassociate [himself or] herself from
prior work product the lawyer knows or has reason to believe is further-
ing the client's continuing or future criminal or fraudulent conduct." This opinion substantiates and reinforces the securities lawyer's power
and responsibility to withdraw from the engagement and to disavow any
disclosure document he or she has prepared if that lawyer knows or
should know the disclosure document is materially misleading and that
the client intends to pass it on to investors.

B. THE COMMON LAW OF TORTS

The interpretation given in ABA Formal Ethics Opinion 92-366 com-
ports with standards derived from the common law of torts, including, in
particular, those principles reflected in the American Law Institute's
(ALI) Restatement (Second) of Torts Sections 526, 529, and 552(1).

Section 526 provides:

A misrepresentation is fraudulent if the maker (a) knows or believes
the matter is not as he represents it to be, (b) does not have the
confidence in the accuracy of his representation that he states or im-
plies, or (c) knows that he does not have the basis for his representa-
tion that he states or implies.

Section 529 provides: "A representation stating the truth so far as it goes
but which the maker knows or believes to be materially misleading be-
cause of his failure to state additional or qualifying matter is a fraudulent

38. Id.
39. Id.
40. Id.
42. Id. § 526 ("Conditions Under Which Misrepresentation Is Fraud (Scienter)").
misrepresentation." 43 Section 552(1) provides:

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information. 44

These restated rules from the evolving common law of torts, which protect the interests of disclosure recipients by imposing liability-enhanced responsibilities upon the suppliers of the information disclosed, have significantly contributed to the standards of practice in the field of securities law. These rules and the standards they have helped develop are particularly critical given the securities lawyer's integral role in the disclosure process. After all, a securities lawyer who prepares a securities offering disclosure document directly participates in providing information to third party investors for their reliance in making investing decisions. As I have previously indicated, the securities lawyer, not the issuer, controls the disclosure process and, by making literally hundreds of materiality determinations, decides the quantity and quality of information to be included in the disclosure documents. Thus, the disclosure document is, in actuality, the securities lawyer's work product. By making that document available to investors through the medium of his or her client issuer, the securities lawyer in a very real sense "supplies" information to prospective investors. Because the securities lawyer undertakes for pecuniary benefit the role of information supplier, it makes little difference whether the information supplied to prospective investors takes the form of an opinion accompanying the disclosure document or the form of the disclosure document itself, or, for that matter, whether the lawyer or law firm is named or not named in the disclosure document. The very structure, organization, and use of language in the disclosure document, coupled with

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43. Id. § 529 ("Representation Misleading Because Incomplete"). See also W. Page Keeton et al., Prosser and Keeton on the Law of Torts § 106 (5th ed. 1984) [hereinafter Prosser and Keeton] ("...half of the truth may obviously amount to a lie if it is understood to be the whole. Again, one who has made a statement, and subsequently acquires new information which makes it untrue or misleading, must disclose such information to anyone he knows to be still acting on the basis of the original statement"). Rose v. Arkansas Valley Envtl. & Util. Auth., 562 F. Supp. 1180, 1207 (W.D. Mo. 1983) (citing both § 529 of the Restatement (Second) of Torts and § 106 of Prosser and Keeton in finding that a duty not to omit was part of a general duty to speak truthfully).

44. Restatement (Second) of Torts § 552(1) ("Information Negligently Supplied for the Guidance of Others"). See also Eisenberg v. Gagnon, 766 F.2d 770 (3d Cir. 1985) (defendant/lawyer tried to frame plaintiffs/investors' charges in terms of malpractice since, as attorney for the limited partnerships, he owed plaintiffs no duty, but the court quoted § 552 in finding a duty of due diligence); Petrillo v. Bachenberg, 655 A.2d 1354, 1358-60 (N.J. 1995) (the court quoted from § 552 in finding attorney had a duty to third parties who "foreseeably rely on the attorney's opinion or other legal services"). The Petrillo court also looked to the reasoning in Molecular Technology Corp. v. Valentine, 925 F.2d 910 (6th Cir. 1991), in finding attorney owed a duty of care. Petrillo, 655 A.2d at 1358. See also Atlantic Paradise Assocs., Inc. v. Perskie, Nehmad & Zeltner, 666 A.2d 211 (N.J. Super. Ct. App. Div. 1995).
commonly held assumptions about its technical legal footing, offer convincing proof to investors that the issuer’s lawyer has prepared and signed off on its contents. Moreover, the securities lawyer obviously anticipates reliance by third parties on his or her work product (since this is a primary reason for the lawyer’s retention) and is fully aware that applicable standards require his or her independent professional judgment, based on competent inquiry and verification, to determine what should or should not be disclosed. Although these foregoing provisions of the Restatement articulate principles of liability frequently utilized in litigation against securities lawyers, they also serve as a source for the securities lawyer’s standard of care to avoid the creation or use of his or her work product if it would materially mislead third party investors, whether by omissions or outright misrepresentations of material facts. By allocating liability to the drafter, these principles serve to inform the securities lawyer’s behavior in managing the disclosure process and producing the disclosure document.

The ALI’s proposed Restatement of the Law Governing Lawyers45 reaffirms these principles. Section 73(3) provides:

[A] lawyer owes a duty [of] care . . . [t]o a non-client when and to the extent that the lawyer knows that a client intends the lawyer’s services to benefit the non-client, and such a duty substantially promotes enforcement of the lawyer’s obligations to the client and would not create inconsistent duties significantly impairing the lawyer’s performance of those obligations.46

In the draft comments, the ALI notes that the analysis is similar regardless of whether third party reliance is placed on the lawyer’s opinion or the lawyer’s other legal services. The provision is intended to “promote the lawyer’s loyal and effective pursuit of the client’s objectives,”47 particularly since the nonclient “may be better situated than the client to enforce the lawyer’s duties to the client”48 because of the client’s physical, commercial, or legal inability to prosecute the claim.

The standards derived from these principles, as restated by the ALI, as well as the duties these principles underscore, have resulted in a highly desirable symmetry that effectively serves the interests of the lawyer, the client issuer, and the client’s investors.49 Stated most simply, the securities laws require the client issuer to make full disclosure to prospective

45. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS (Tentative Draft No. 7, 1994).
46. Id. § 73 (“Duty to Certain Non-Clients”). See also Atlantic Paradise, 666 A.2d at 214 (despite claims by defendant law firms that they owed no duty to purchaser, the appellate court reversed the trial court’s grant of summary judgment to the law firms, relying on Pettilo’s analysis which quoted § 731).
47. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 73 cmt. f (Tentative Draft No. 7, 1994).
48. Id.
49. See FDIC v. O’Melveny & Meyers, 969 F.2d 744 (9th Cir. 1992), rev’d on other grounds, 114 S. Ct. 2048 (1994). In this case, the defendant law firm conceded a duty to investors in a securities offering, but argued it owed no duty to uncover a client’s fraud nor to advise the world of that fraud. According to the court:
investors; the client retains and pays legal fees to the securities lawyer, who in turn exercises the required independent professional judgment to determine and provide the disclosures ultimately made; and the non-clients to whom that information is supplied make investment decisions to benefit them as a class when they transfer capital to the client. In the first instance, the securities lawyer is obligated to protect his or her client against liability for nondisclosure to nonclient investors, and, concomitantly, to protect against his or her own liability both to the client and these nonclient investors. As a consequence, these nonclient investors are enabled by the lawyer to make informed investment decisions, which, after all, is the overriding policy of the securities laws. In turn, the client is enabled to benefit from the nonclients' investments in its business enterprise. Thus, if the securities lawyer abides by applicable standards, the interests of all participants, including his or her own, are symbiotically connected for the achievement of each participant's objectives. Remotely distant from the lawyer's traditional adversarial role, the securities lawyer, in effect, forges the connection between the client and its investors to promote their common interests.

C. THE SEC'S ROLE IN THE DEVELOPMENT OF STANDARDS

The SEC, as the administrative agency charged with implementation of the federal securities laws, has never retreated from its longstanding position that securities lawyers are charged with a public trust to assist in the enforcement of its disclosure regimen. The SEC has repeatedly emphasized that the lawyers' duties extend both to the issuer and to the investors. The SEC's position has been advanced in aggressive litigation under Rule 10b-5, its zeal exemplified best, perhaps, by its arguments in SEC v. National Student Marketing Corp.\(^5\) Although its assertions in that case—that the securities lawyer should be an undercover policeman—were properly rejected,\(^5\) the SEC nevertheless succeeded in heightening the securities lawyer's standard of care. As a consequence, practitioners, mo-

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\(51\) Id. at 712-17.
tivated in large part by fear of dire personal and professional consequences, tightened up their disclosure and due diligence practices. In coming to grips with their role as captains at the disclosure helm, they forever rejected the "can do" response to clients made previously by a large minority of the securities bar.

The SEC also has strongly influenced the behavior, and hence the standards, of securities lawyers through disciplinary proceedings under Rule 2(e) of its Rules of Practice brought against lawyers for "unethical or improper professional conduct." Although its Rule 2(e) decisions do not purport to impose Rule 10b-5 liability on lawyers, they have been significantly influential in the development of securities lawyers' duties to investors and the evolution of standards of care applicable to securities lawyers in adhering to their obligations in the disclosure process. In its proceeding, In re Keating, Muething & Klekamp, the SEC emphasized the vital role lawyers play in assuring adherence to the federal securities laws:

Clearly, the Commission would be unable to administer effectively those laws in an environment in which issuers ... were not routinely served by professionals of the highest integrity and competence, well-versed in the requirements of the statutory scheme Congress has created. An incompetent or unethical practitioner has the ability to inflict substantial damage on the Commission's processes, and thus the investing public, and to the level of trust and confidence in our capital markets.

Similarly, in In re Fields, the SEC opined:

Members of this Commission have pointed out time and time again that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders. These were statements of what all who are versed in the practicalities of securities law know to be a truism, i.e., that this Commission ... is peculiarly dependent on the probity and diligence of the professionals who practice before it. ... This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents that they produce. Hence we are under a duty to hold our bar to appropriately rigorous standards of professional honor.

Here, the SEC restates the truism that virtually all securities lawyers recognize: it is the lawyer who produces the disclosure document, and it is the investor who relies on the lawyer's work in making investment decisions. In perhaps its best known Rule 2(e) proceeding, In re Carter, the

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52. 17 C.F.R § 201.2(e) (1995).
53. 17 C.F.R. § 201.2(e)(1)(ii).
55. Id. at 81,991.
57. Id. at 83,173 n.20.
SEC added that when a lawyer has a significant role in effectuating his or her client's disclosure requirements and the client fails to satisfy those requirements, the lawyer's continued participation constitutes "unethical or improper professional conduct." Moreover, the SEC has continually used remedial sanctions in consent decrees to enforce and publicize the securities lawyer's standards of care. For example, in *In re Ferguson*, the SEC imposed numerous changes in the defendant bond lawyer's disclosure practices in connection with securities offerings. It required, among other things, that the lawyer's engagement letter must emphasize that his duties run to both the issuer and the investors in the issuer's securities and that the lawyer must investigate both his own client and the other participants in the securities offering in order to detect and correct the information set forth in the disclosure document. The SEC's pronouncements have not fallen on deaf ears. They have terrified the general practitioner, segregated a uniquely complex area of highly-specialized practice, and upgraded the standards of care applicable to securities lawyers. Over twenty years ago, one prominent practitioner, in urging the securities bar to develop its own formal standards of care, observed that the SEC "is most serious when it states that attorneys involved in securities transactions must act as guardians of the interests of the investing public." He agreed that securities lawyers, under even then recognized professional standards, are not "alter egos" of their clients' desires but have responsibilities to the investing public, "particularly where the law is designed to protect the public from fraud in securities transactions." After all, he acknowledged, securities lawyers, positioned as the draftsmen or reviewers of the disclosure document, must continually decide, based on their own professional judgment, what matters are or are not material and thus ripe for disclosure to the investing public. Although the securities bar has never formulated express standards, at least one subgroup, the bond lawyers, has published statements addressing their disclosure roles and their professional responsibilities in securities offerings. The National Association of Bond Lawyers has acknowledged the critical role of securities lawyers in the disclosure process, including their rigorous investigatory and disclosure responsibilities and their duties to investors who understandably and

59. *Id.* at 84,172.
60. 5 SEC Docket 37, SEC Admin. Proc. File No. 3-4528 (Aug. 21, 1974).
61. *Id.* at 38 n.3.
63. *Id.* at 619 n.45.
64. *Id.* at 631.
predictably rely on their work. Clearly no securities lawyer can argue with a straight face that he or she is merely a green eye-shaded transcriber in the backroom who puts pen to paper to record the dictation of his or her client. On the contrary, the securities lawyer operates under standards that require his or her control over the flow of information to the client's investors. Controlling the flow is primary participation in any offering of securities.

D. Standards Derived from Judicial Pronouncements

The standards applicable to securities lawyers are also derived from instructive pronouncements set forth in numerous judicial opinions addressing the role of lawyers in preparing disclosure documents for offerings of securities. Although actual judicial holdings, some of which I will address in the succeeding section of this Article, certainly have influenced the development of those standards, judicial expressions in securities law opinions, whether categorized as dicta or holdings, have significantly affected the behavior of securities lawyers involved in the preparation of disclosure documents. This critical distinction must be observed because prudent securities lawyers do not perform their services on the line of liability, but far above it. Unlike trial lawyers who sometimes view themselves as hired guns at shootouts or transactional lawyers who sometimes shape their clients' conduct so as to stay barely within the margins of the law, securities lawyers are noted for their refined sensitivities to highly technical disclosure requirements and a marked skepticism tantamount to suspicion. Because their responsibilities are to detect and disclose, fully aware of third party reliance on their work product, they strive to follow both the letter and spirit of the securities laws. Thus, performance based standards have developed not so much from rulings for or against a particular lawyer, but from insights gained independent of the outcome from judicial expressions regarding the securities lawyers' role.

Of course, I cannot begin to make an all-inclusive list of these behavior-shaping judicial statements, and, accordingly, I will only provide some of the more important ones that are perhaps most frequently referred to by the securities bar and by judges addressing professional misconduct in the context of securities litigation. An appropriate starting point is to examine statements made by Judge Friendly in two important decisions rendered some thirty years ago, United States v. Benjamin and SEC v. Frank. In Benjamin, a criminal case brought against a lawyer and others involved in an offering described as "another of those sickening financial frauds," the court rejected the defense of ignorance asserted

67. "Most bond counsel probably consider . . . that their most significant responsibilities are to the ultimate investors. . . ." Id. at 16.
68. 328 F.2d 854 (2d Cir. 1964).
69. 388 F.2d 486 (2d Cir. 1968).
70. Benjamin, 328 F.2d at 856.
by the lawyer for the promoter. In his now oft-cited conclusion that the lawyer had committed wilful fraud, Judge Friendly stated:

In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.71

Similarly, in SEC v. Frank, Judge Friendly flatly rejected the lawyer's "I am only a scrivener" defense and stated:

A lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him. . . . [A] lawyer, no more than others, can escape liability from fraud by closing his eyes to what he saw and could readily understand.72

Then Judge Kaufman, in SEC v. Spectrum, Ltd.,73 in an opinion adopting the SEC's view that securities lawyers have public trust responsibilities, stated:

The securities laws provide a myriad of safeguards designed to protect the interests of the investing public. Effective implementation of these safeguards, however, depends in large measure on the members of the bar who serve in an advisory capacity to those engaged in securities transactions. The standard of diligence demanded of the legal profession to meet this responsibility is a matter on which we are required to comment . . . .74

The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he or she renders an opinion on such matters.75

In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its legal advisers than 'customary' activities which prove to be careless.76

It is important to note that Judge Kaufman expressly rejected the argument that an investigatory burden upon lawyers engaged in "customary

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71. Id. at 863.
72. Frank, 338 F.2d at 489.
73. 489 F.2d 535 (2d Cir. 1973).
74. Id. at 536.
75. Id. at 541-42.
76. Id. at 542.
business activities" would be too great. The court pointed out, in effect, that the securities lawyer participating in an offering of securities is not performing "customary" or "routine" legal services, particularly given his or her knowledge that nonclient investors will substantially rely on the lawyer's work product. Instead, because of his or her unique and pivotal role in the disclosure process, the securities lawyer is a primary participant with unique duties to prospective investors.

Perhaps the most influential decision regarding lawyer behavior in connection with the preparation of disclosure documents is Escott v. Bar-Chris Construction Corp. The court began by noting the "unique position" which the attorney occupied as the person "most directly concerned with writing the registration statement and assuring its accuracy" and that "more was required of him in the way of a reasonable investigation." Despite the court's finding that the lawyer "honestly believed that the registration statement was true and that no material facts had been omitted," the court concluded that he had not made a reasonable investigation. In reaching this conclusion, the court made a number of highly instructive observations:

It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes. The statute imposes liability for untrue statements regardless of whether they are intentionally untrue. The way to prevent mistakes is to test oral information by examining the original written record.

There were things which [the lawyer] could readily have checked which he did not check. For example, he was unaware of the provisions of the agreements between [the issuer and the factor]. He never read them. Thus, he did not know, although he readily could have ascertained, that [the issuer's] contingent liability on ... lease-back arrangements was [one hundred percent], not twenty-five percent. He did not appreciate that if [the issuer] defaulted in repurchasing delinquent customers' notes upon [the factor's] demand, [the factor] could accelerate all the customer paper in its hands, which amounted to over $3,000,000.

As far as customers' delinquencies are concerned, although [the lawyer] discussed this with [management], he again accepted the assurances of [management] that no serious problem existed. He did not examine the records as to delinquencies, although [the issuer] maintained such a record. Any inquiry on his part of [the factor] or

77. Id.
79. Id. at 690.
80. Id.
81. Id.
an examination of [the issuer's] correspondence with [the factor] . . . would have apprised him of the true facts.

. . . [The lawyer] was obliged to make a reasonable investigation. I am forced to find that he did not make one. After making all due allowances for the fact that [the issuer's] officers misled him, there are too many instances in which [the lawyer] failed to make an inquiry which he could easily have made which, if pursued, would have put him on his guard.\textsuperscript{82}

The lawyer defendant in \textit{Escott} was sued as a director of the issuer under Section 11 of the Securities Act of 1933. Nonetheless, the court's language has been broadly accepted by securities lawyers as integral to their standards of care whenever they are engaged as draftsmen of disclosure documents for public or private securities offerings.\textsuperscript{83}

The significance of the statements from the foregoing opinions is exemplified by frequent reference to them in both legal literature\textsuperscript{84} and in the cases which succeeded them. Although these pronouncements only generally outline the applicable standards, courts have found them quite useful as constructs for analysis in assessing particular lawyer behavior. This is perhaps best illustrated in \textit{Felts v. National Account Systems Ass'n},\textsuperscript{85} in which the court looked to \textit{Spectrum} (which cited \textit{Benjamin}, \textit{Frank}, and \textit{Escott} to identify the "special duties" to investors imposed on a lawyer preparing securities disclosure documents, including "the obligation to exercise due diligence," the duty never to "assist the [issuer] circulate statements he knows or should know to be false simply because they were furnished to him by the client," and the duty to "make a reasonable, independent investigation to detect and correct false or misleading materials."\textsuperscript{86} Then, applying the corollary standards of care to the facts, the court concluded that the lawyer defendant breached his special duties of diligent investigation and disclosure by failing to make a reasonable inquiry to ascertain the truth or falsity of the representations furnished to him by his client. Accordingly, the court held that the lawyer defendant was a "participant" in the sale and thus liable as a primary violator of

\textsuperscript{82} Id. at 692.

\textsuperscript{83} According to one practitioner, "fairly standardized procedures of due diligence have been generally established and well publicized by the bar ever since the [\textit{Escott v.}] \textit{BarChris} decision slammed home the need to check the written record and to document all investigatory and verification efforts." Cheek, supra note 62, at 629. These due diligence standards, of course, are applicable both to public and private offerings of securities. Another practitioner states:

\begin{quote}
Attorneys must be cognizant of the risks of engagements involving clients with short or poor track records or risky business plans. Because they are usually new ventures, and placement agents assuming due diligence responsibilities are often not involved, private placements are inherently more risky. Considering the increased risks and the attorney's potential status as the only independent party to the due diligence process, the investigatory aspects of the engagement arguably should be as broad or broader than for public offerings.
\end{quote}

Donohue, supra note 49, at 140.

\textsuperscript{84} See, e.g., Cheek, supra note 62; Donohue, supra note 49.

\textsuperscript{85} 469 F. Supp. 54 (N.D. Miss. 1978).

\textsuperscript{86} Id. at 67.
IV. JUDICIAL IMPOSITION OF PRIMARY LIABILITY

In recent years, both prior and subsequent to the Supreme Court’s decision in *Central Bank*, the courts have not been reluctant to impose primary liability on securities lawyers engaged in the preparation of disclosure documents for securities offerings. Although the decisions have been by no means consistent, with several concluding otherwise, a majority view has emerged that primary liability is appropriate where the securities lawyer has recklessly departed from the applicable standards of care. As discussed previously, the standards of care arise from the actual role assumed by these lawyers, as augmented by SEC and judicial pronouncements, in fulfilling their “special duties” both to the client issuer and the nonclient investors who foreseeably rely on the securities lawyer’s work product. These standards of care require extensive lawyer involvement not only in preparing a legal document, but in discovering, verifying, and selecting the information which constitutes the content of that document. The lawyer thus controls the flow of information to the nonclient investor and, therefore, is properly viewed as “making” or “furnishing” the information to those investors. If a misrepresentation or omission is so made or furnished to investors by means of the disclosure document the lawyer has prepared, then it is the lawyer, and not the client issuer alone, who has made the misrepresentations or omissions in connection with the investors’ purchase of securities. If materiality, reliance, causation, and damages are assumed, then the lawyer’s ultimate liability will be determined by addressing the remaining requisite element of Rule 10b-5, intent to deceive or scienter, as required by the Supreme Court.

87. *Id.* at 68. In turn, the discussion in *Felts* addressing the securities lawyers’ special duties to nonclient investor was extensively relied upon by the Ninth Circuit in *O’Melveny & Meyers*, which held that securities lawyers owe the same special duties to their clients. *O’Melveny & Meyers*, 969 F.2d 744, 752 (9th Cir. 1992), rev’d on other grounds, 114 S. Ct. 2048 (1994).

88. In *In re Rospatch Securities Litigation*, Judge Hillman deftly criticized three decisions frequently relied upon by attorneys seeking to evade primary liability: *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), cert. denied, 112 S. Ct. 1475 (1992); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986); and *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988), vacated on other grounds, 492 U.S. 914 (1989). *In re Rospatch Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,939, at 93,973 (W.D. Mich. July 8, 1992). Judge Hillman pointed out that neither *Schatz* nor *Barker* involved lawyer defendants who had prepared or reviewed disclosure documents expected to be relied upon by investors and that *Abell*, a decision lacking factual clarity as to exactly what documents were prepared by defendants, was vacated. Lastly, the judge focused on ethical grounds, citing with approval Geoffrey Hazzard’s critique of *Schatz* for its conclusion “that lawyers ‘have a special immunity’ from the responsibility not to assist a client in making a representation the lawyer knows to be fraudulent.” *In re Rospatch Sec. Litig.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,979. Hazzard, one of the nation’s leading experts on legal ethics, has written that *Schatz*, “as a matter of legal reasoning . . . is obviously and egregiously wrong,” “contradicts long-established case law,” and “if it is correct, would give lawyers a license to steal.” Geoffrey C. Hazzard, Jr., *Ruling Errs on Legal, Moral Basis*, 14 Nat’l L.J., Jan. 20, 1992, at 17.
Court in *Ernst & Ernst v. Hochfelder*. Because proof of actual intent is generally difficult, the federal courts in every federal judicial circuit have held that the scienter requirement may be satisfied by proof of recklessness, generally defined as an extreme departure from the applicable standards of care. If the plaintiff is unable to meet this burden, for example, by showing that the lawyer was merely negligent under the applicable prudent expert standard, then the lawyer will escape primary liability under Rule 10b-5.

The court in *Felts* was not among the first to impose primary liability on securities lawyers under Rule 10b-5. In 1972, the court in *Blakely v. Lisac*, relying extensively on *SEC v. Frank*, held that an attorney with primary responsibility for drafting the prospectus and other disclosure documents was primarily liable to investors under Rule 10b-5 as a result of misleading financial information set forth in the prospectus "which he should have investigated." In essence, the court found the requisite proof of scienter from the lawyer's failure to sustain what was described as "his due diligence defense." This failure of due diligence in the Rule 10b-5 context must be viewed as equivalent to a reckless failure to abide by applicable standards of care requiring an investigation and due diligence with respect to disclosures made in the prospectus. Similarly, in *Reingold v. Deloitte Haskins & Sells*, another court relied exclusively on *Frank* to reject the defendant lawyer's contention that in reviewing and filing various disclosure documents he was merely "a lawyer acting in a professional advisory capacity and that such actions cannot subject him to Rule 10b-5 liability." The court simply noted that the defendant "largely ignores SEC v. Frank, which squarely refutes this argument." And, in *In re Flight Transportation Corp. Securities Litigation*, the court found a duty to disclose on the part of the defendant lawyer and, hence, potential primary liability under Rule 10b-5 based solely on the lawyer's undertaking to prepare the allegedly false and misleading prospectus. These and similar decisions upholding primary liability for attorneys who have prepared false or misleading disclosure documents find considerable support in similar decisions upholding primary liability for attorneys who have prepared false or misleading legal opinions in connection with securities offerings.

89. 425 U.S. 185 (1976).
90. See supra note 14.
92. 388 F.2d 486 (2d Cir. 1968).
94. Id.
96. Id. at 1269.
97. Id. (citation omitted).
99. Id. at 617-18.
100. See, e.g., *Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856 (10th Cir. 1980). In this case of "flagrant fraud," a municipal bond broker dealer sold high risk industrial development bonds to returning Vietnam-era prisoners of war as safe and secure investments.
In recent years, the trend toward imposition of Rule 10b-5 primary liability on lawyers as a consequence of their preparation of misleading disclosure documents has strengthened considerably and, as stated previously, now can be fairly described as the majority view. Certain of these decisions are particularly instructive and should be briefly considered. The Second Circuit, in *Breard v. Sachnoff & Weaver, Ltd.*,\(^{101}\) concluded that lawyers preparing disclosure documents for securities offerings owe a duty of disclosure to investors. The law firm defendant, as counsel to a limited partnership issuer, had drafted an offering memorandum used by the client issuer to secure capital.\(^{102}\) When the project failed, the investors brought suit under Rule 10b-5 alleging that the law firm had omitted and misstated material facts in the disclosure document, including negative information regarding the background of one of the project's promoters. In reversing the trial court's dismissal of the claim, the Second Circuit squarely held that lawyers who knowingly or recklessly prepare materially misleading solicitation documents in connection with a securities offering may be held liable as primary violators of Rule 10b-5.\(^{103}\)

Another court, consistent with the Second Circuit's holding in *Breard*, concluded that a lawyer who prepares a misleading disclosure document is a primary participant in the securities offering. In *Mercer v. Jaffee, Snider, Raitt and Heuer, P.C.*,\(^{104}\) the plaintiff sought to impose primary liability on defendant attorneys for having "'knowingly or in a reckless disregard of the truth' approved or assisted in the preparation of false and misleading offering circulars."\(^{105}\) According to the court, Rule 10b-5 primary liability requires "direct participation in the deceit at issue."\(^{106}\) One who undertakes to furnish information containing material misstatements or omissions is a primary participant, the court stated, so long as "not so far removed from the transmission of the misleading information that liability would necessarily become vicarious."\(^{107}\) Then the court held

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Among the defendants in this case were two law firms that had acted as bond counsel to the issuer. After the district court granted summary judgment to defendants based on their ignorance of the fraud, the Tenth Circuit reversed. It held that if defendants had participated in the issuance of the bonds, they owed a duty of disclosure to all investors. *Id.* at 859. *See also* *Rose v. Arkansas Valley Envtl. & Util. Auth.*, 562 F. Supp. 1180 (W.D. Mo. 1983) (the court denied motion to dismiss by defendant lawyers, finding the affirmative actions of the defendant lawyers in communicating the information in the bond opinion created a duty to state omitted materials); *Eisenberg v. Gagnon*, 766 F.2d 770 (3d Cir. 1985); *Kline v. First W. Gov't Sec.*, 24 F.3d 480 (3d Cir. 1994) (the court concluded attorneys may be liable for misrepresentations and omissions where their legal opinion becomes materially inaccurate or incomplete). *See generally* Joseph L. Johnson, III, Note, *Liability of Attorneys for Legal Opinions Under the Federal Securities Laws*, 27 B.C. L. Rev. 325 (1986).

101. 941 F.2d 142 (2d Cir. 1991).
102. *Id.* at 143.
103. *Id.* at 144.
105. *Id.* at 1025.
106. *Id.*
107. *Id.*
that the attorneys' approval or alleged assistance in the preparation of misleading disclosure documents constituted "conduct [that] certainly qualifies as 'furnishing' or 'supplying' information to potential investors in a sufficiently direct manner to impose 10b-5 primary liability."108 In reaching its conclusion, the court relied on the Sixth Circuit's opinion in \textit{SEC v. Washington County Utility District},109 which explained the "direct contacts" or "direct participation" prerequisite to primary liability under Rule 10b-5. In that case, which relied heavily on \textit{SEC v. Coffey},110 the court noted that "[d]irect contacts require neither physical presence nor face to face conversation," but is satisfied when one undertakes to furnish misleading information.111 According to the court in \textit{Mercer}, this is exactly what an attorney does when he undertakes to prepare a misleading disclosure document which he knows will be relied upon by investors.

In \textit{Molecular Technology Corp. v. Valentine},112 the Sixth Circuit directly confronted the issue of an attorney's primary liability under Rule 10b-5. In this case, corporate counsel for the issuer had prepared a private placement memorandum for a debenture offering and forwarded it to outside counsel for review. The court, after examining the record below, concluded that outside counsel knew or should have known that the offering memorandum that he edited failed to disclose certain material facts regarding the issuer. Consistent with the principles applied in \textit{Mercer}, the Sixth Circuit concluded that the lawyer's involvement satisfied the "direct contacts" test, and, accordingly, that the lawyer, as a primary participant in the disclosure process, could be held liable as a primary violator of Rule 10b-5.113 The court's opinion properly recognizes that the securities lawyer, far from being an "extra" in the disclosure production, has a starring role. Thus, the investors should not be and are not required to prove some other special relationship between the lawyer and themselves which would establish a separately based duty to disclose.114

In another case, \textit{In re Rospatch Securities Litigation},115 the court followed \textit{Molecular Technology} to reach a similar result. Again, outside legal counsel had prepared disclosure documents on behalf of the issuer that allegedly failed to disclose the issuer's severe financial difficulties.

108. \textit{Id.}.
109. 676 F.2d 218 (6th Cir. 1982).
110. 493 F.2d 1304 (6th Cir. 1974).
112. 925 F.2d 910 (6th Cir. 1991).
113. \textit{Id.} at 918.
114. \textit{Id.} at 917. According to Professor Marc Steinberg, a fellow contributor to this Symposium Issue, the court's decision in \textit{Molecular Technology} literally "means that when lawyers draft a prospectus, there is no need to go to aiding and abetting liability, fiduciary duty rationales, and so on." Timothy E. Hoberg, \textit{1993 Corporate Law Symposium: Presentations and Panel Discussion}, 62 U. Cin. L. Rev. 533, 555 (1993) (statement by Professor Marc Steinberg as part of a panel discussion).
According to the court, the defendant law firm was fully aware that the documents it prepared would be made public and relied upon by the issuer's investors. In its defense, the law firm argued that it had no duty to disclose to the plaintiff investors because (1) the law firm itself did not make independent material misstatements to the investors, (2) it had no direct dealings with the investors, and (3) it was not in a fiduciary relationship with the investors. Applying the direct contacts test, the court held that the law firm's preparation of the various disclosure documents constituted the requisite direct contacts, and, consequently, the law firm had a legal duty to disclose material omissions to investors in the documents that it prepared.\(^{116}\) Moreover, the court rejected as inapposite the law firm's argument that its work on the disclosure documents filed with the SEC was not done for the purpose of selling securities. In response, the court noted that the law firm knew the disclosure forms would be issued to the public and read by purchasers of the issuer's securities, clearly "enough to satisfy the requirement that the misstatements occur 'in connection with' the purchase or sale of a security."\(^{117}\)

The final case I will address in this Article is an important decision decided subsequent to Central Bank, Employers Insurance v. Musick, Peeler & Garrett,\(^{118}\) a controversy previously considered by the Supreme Court on the issue of whether a cause of action for contribution was permissible under Rule 10b-5.\(^{119}\) The plaintiffs in this case alleged that the attorneys and accountants were "the actual architects" of disclosure documents containing material misrepresentations and omissions. While acknowledging that the aiding and abetting theory of liability decimated by Central Bank was easier to plead than a theory of primary liability under Rule 10b-5, the court recognized that the latter theory remained fully available to plaintiffs against lawyers who have drafted a materially misleading prospectus. The defendant lawyers asserted that this was a failure to disclose case, and, hence, the plaintiff must first establish the attorneys' duty to disclose to investors. Instead of turning to the "special duties" to investors confirmed in Feltz, the court pointed out that this was not a failure to disclose case, but rather an affirmative misrepresentation or omission case.\(^{120}\) The defendant attorneys were not completely silent, for quite unlike the printer defendant in Chiarella v. United States,\(^{121}\) they were alleged to have drafted the entire prospectus which contained misrepresentations, with resultant omissions "arising out of an overall body of representations made in the prospectus."\(^{122}\) Given this critical distinction, the plaintiffs are not required to demonstrate a duty to disclose where the defendant lawyers are alleged to have participated in drafting

116. Id. at 93,979.
117. Id. at 93,980.
120. Musick, Peeler, 871 F. Supp at 389.
Relying on two Ninth Circuit opinions, *In re Software Toolworks Inc. Securities Litigation* and *SEC v. Seaboard Corp.*, the court agreed with the principle that a secondary actor may be primarily liable when the actor's participation consists primarily of drafting and editing a securities offering disclosure document. Thus, the court in *Musick, Peeler*, consistent with both the "direct contacts" analysis used by the Sixth Circuit and the "duty to disclose" analysis originating in *Frank* and amplified in *Felts*, concluded that the defendant attorneys could be primarily liable under Rule 10b-5 based on allegations that they participated in the preparation of disclosure documents that they knew or were reckless in not knowing contained material misrepresentations or omissions.

123. *Id.*
124. 38 F.3d 1078 (9th Cir. 1994).
125. 677 F.2d 1301 (9th Cir. 1982).

Although this Article deals with the primary liability of securities lawyers, accountants providing services in connection with securities disclosure documents also are frequently found to be primarily liable under Rule 10b-5. *See SEC v. Seaboard Corp.*, 677 F.2d 1301 (9th Cir. 1982) (generally accepted accounting standards do not provide protection from liability when an accountant fails to disclose material facts he knew or should have known should be revealed); *Bradford White Corp. v. Ernst & Whinney*, 872 F.2d 1153 (3d Cir. 1989) (liability based on accountants' failure to conduct audit in accordance with generally accepted auditing standards, where accountants represented that the audit conformed to those standards); *Spear v. Ernst & Young*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,399, at 90,739 (D.S.C. Aug. 15, 1994) (materially false and misleading opinions
V. CONCLUSION

In this Article I have addressed the role of securities lawyers in the preparation of disclosure documents for securities offerings and have explained how the applicable standards of care, as derived from several important sources, impose upon those lawyers the status of primary participants. The numerous decisions upholding the applicability of Rule 10b-5 primary liability to lawyers involved in the preparation of misleading disclosure documents are clearly consistent with the underlying disclosure philosophy of our federal securities laws. They are also consistent with the pronouncements of the SEC, the courts, and the securities bar that the effective implementation of those disclosure laws largely depends upon compliance by securities lawyers with ethical and professional standards designed to protect both client and investor interests. These standards not only establish the securities lawyer's extensive involvement as a supplier of information, but also provide the prudent expert standards of care against which scienter or recklessness will be measured. The securities lawyer who abides by those standards, as well as the securities lawyer who is merely negligent in undertaking to abide by those standards, is not subject to primary liability under Rule 10b-5. In fact, securities lawyers may well take comfort from the independence the portent of primary liability assures. As a result of this liability risk, the securities lawyer is better positioned to conduct his or her investigation with the required detachment, successfully substituting disclosure independence for client bias. Thus, the imposition of primary liability under Rule 10b-5 serves to promote the symmetry of interests sought to be achieved by both the federal securities laws and the applicable standards of care to provide improved disclosure intended to reduce investment risks for third party investors and liability risks for securities lawyers and their clients.

or fraudulent financial statements coupled with accountants' knowledge that stock purchasers would rely on opinions satisfies the "in connection with" requirement of § 10(b)); Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398 (N.D. Cal. 1995) (accounting firm may be primarily liable for misrepresentations and omissions by others where they have a significant role in drafting or editing a disclosure document).